*Mayo v. Dean Witter Reynolds, Inc.**

I. INTRODUCTION

As arbitration clauses become popular features in the terms and conditions of account agreements between banking and investment firms, states have struggled with ensuring that the designated arbitral fora are fair to consumers. Recently, however, the securities industry gained an advantage when a United States District Court found that a valid arbitration clause administered by the Securities Exchange Commission (SEC) could be enforced because the applicable federal law preempted stricter, more protective state standards.[1]

II. CASE HISTORY

Plaintiff Richard Mayo opened an investment account with Morgan Stanley Dean Witter & Company ("Morgan Stanley") in June of 2000.[2] The account agreement Mayo signed required consent to abide by all terms and conditions, including a provision specifying that all disputes between the parties would be subject to binding arbitration.[3]

A. *Basis of the Suit*

Mayo's suit arises from thousands of dollars of unauthorized point-of-sale and automated teller machine (ATM) transactions he reported to Morgan Stanley, which occurred in October and November of 2000.[4] While Morgan Stanley credited the amount of the point-of-sale transactions to Mayo's account, it refused to credit the amount of the ATM withdrawals.[5] Mayo, a California resident, filed suit in a California state court claiming that Morgan Stanley's refusal to credit the amount of the ATM transactions violated both the Electronic Funds Transfer Act[6] and California's Unfair Competition

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* Mayo v. Dean Witter Reynolds, Inc., 258 F. Supp. 2d 1097 (N.D. Cal. 2003).

[1] *See id.* at 1116.

[2] *Id.* at 1099.

[3] *Id.*

[4] *Id.*

[5] *Mayo*, 258 F. Supp. 2d at 1099.

[6] 15 U.S.C. § 1693 (2003).

Law.[7] Morgan Stanley removed the case to federal court, and thereafter, moved to compel arbitration.[8]

In accordance with the arbitration provision of the account agreement, Mayo filed with the New York Stock Exchange (NYSE) to commence arbitration.[9] Under the terms of the submission, as well as the approved rules of the NYSE,[10] the arbitration would be governed by the "'Constitution, By-Laws, Rules, Regulations, and/or Code of Arbitration Procedure of the sponsoring organization.'"[11] Before an arbitrator could be appointed, the Judicial Council of California promulgated new ethics standards for arbitrators,[12] which the NYSE claimed were in conflict with the standards it is bound to follow under its SEC-approved rules.[13] Because of the effect of the standards, the NYSE informed Mayo that it had temporarily suspended the appointing of arbitrators in California.[14]

1. *The California Ethics Standards*

The Ethics Standards for Neutral Arbitrators in Contractual Arbitration ("Standards")[15] apply to any person sitting "as a neutral arbitrator pursuant to an arbitration agreement."[16] The Standards apply to any arbitrator appointed on or after the effective date of July 1, 2002, and generally favor individual consumers over corporations.[17] Intended to "promote public confidence in

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[7] CAL. BUS. & PROF. CODE § 17200.

[8] *Id.*

[9] *Id.* at 1100.

[10] As a self-regulating organization (SRO), the NYSE is registered and closely monitored by the Securities and Exchange Commission (SEC). *See generally* Securities Exchange Act of 1934, 15 U.S.C. § 78s (2000) (containing supervisory provisions governing SROs). Under the Securities Exchange Act, an SRO's rules and regulations must be approved by the SEC prior to their implementation. § 78s(b)(1). As one of its functions, the NYSE provides arbitration to resolve disputes in the securities industry. *Mayo*, 258 F. Supp. 2d at 1102. The arbitral process is regulated by the SEC. *Id.* The NYSE must comply with both the Securities Exchange Act and the provisions of its own rules. *See* § 78s(g).

[11] *Mayo*, 258 F. Supp. 2d at 1100.

[12] *Id.*

[13] *See id.* at 1102.

[14] *Id.* at 1100.

[15] The Standards are codified in Division VI of the Appendix to the California Rules of Court. *See* CAL. R. CT. tit. 7, ch. 6, App. Div. VI (West Supp. 2003).

[16] CAL. CIV. PROC. CODE § 1281.85 (West Supp. 2003).

[17] *Mayo*, 258 F. Supp. 2d at 1100–01.

the arbitration process,"[18] the Standards include increased disclosure requirements for arbitrators.[19] For example, an arbitrator must disclose "all matters that could cause a person aware of the facts to reasonably entertain a doubt that the proposed arbitrator would be able to be impartial."[20] Standard 8 provides additional disclosures in consumer arbitrations "in which a dispute resolution provider organization is . . . administering the arbitration."[21]

2. *Sanctions*

Failure to make the required disclosures results in arbitrator disqualification upon a motion by any party entitled to the disclosure.[22] More importantly in the *Mayo* case, section 1286.2 of the California Code of Civil Procedure provides that an arbitration award may be vacated if the court determines that the arbitrator (1) failed to provide timely disclosure of information of which the arbitrator was aware, which would be ground for disqualification, or (2) was subject to disqualification but failed, upon demand, to disqualify himself or herself.[23] "In other words, failure to comply with the disclosures required by the . . . . [S]tandards results in mandatory vacatur of an arbitration award."[24]

B. *Opposition by the NYSE and SEC*

The NYSE filed a complaint for declaratory relief against the Judicial Council of California, seeking an exemption for self-regulating organizations (SROs) and arguing that the Standards conflicted with its own SEC-approved rules.[25] The NYSE and the SEC, as amicus, argued that the Securities Exchange Act and the Federal Arbitration Act preempt the Standards, thus exempting SROs (*e.g.*, the NYSE) from compliance.[26] The NYSE continued

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[18] CAL. R. CT. tit. 7, ch. 6, App. Div. VI, standard 1(a) (West Supp. 2003).

[19] *See generally* CAL. R. CT. tit. 7, ch. 6, App. Div. VI (West Supp. 2003).

[20] *Id.* at Standard 7(d).

[21] *Id.* at Standard 8(b).

[22] *Id.* at Standard 10.

[23] *Mayo*, 258 F. Supp. 2d at 1101.

[24] *Id.*

[25] *Id.* at 1102.

[26] *Id.*

its temporary moratorium on assigning arbitrators in California[27] and designated Reno, Nevada as the site of Mayo's arbitration hearing.[28]

C. *Mayo's Motion to Vacate*

Refusing to arbitrate out of state, Mayo filed a motion to vacate the arbitration order on the grounds that the moratorium on the assignment of California arbitrators made the agreement to arbitrate void for impossibility, frustration of purpose, and unconscionability.[29] Morgan Stanley, the NYSE, and the SEC opposed Mayo's motion on the basis that the Federal Arbitration Act and the Securities Exchange Act preempt the Standards.[30]

Despite Mayo's failure to follow appropriate procedural requirements,[31] the court examined the merits of the case "because of the importance of the issues to be decided."[32]

III. HOLDING OF THE COURT

The court held that the Securities Exchange Act and Federal Arbitration Act (FAA) preempt the California ethics standards[33] because (1) the parties had elected to be governed by federal law,[34] (2) the Standards conflicted with

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[27] *Id.* The NYSE did, however, offer investors the option of arbitrating their claims outside of California where the Standards would not apply. *Id.*

[28] *Mayo*, 258 F. Supp. 2d at 1102. In November 2002, the NYSE declaratory relief action was dismissed on the ground that defendants had Eleventh Amendment immunity. *Id.* At the same time, the SEC granted approval of an interim NYSE rule requiring California investors to either waive the Standards in order to proceed with arbitration in California, or proceed with out-of-state arbitration. Self-Regulatory Organizations, 67 Fed. Reg. 69,793 (Nov. 12, 2002).

[29] *Mayo*, 258 F. Supp. 2d at 1102.

[30] *Id.* at 1103.

[31] Mayo did not clarify under what authority he filed his motion to vacate the arbitration order. The court briefly examined Federal Rules of Civil Procedure 59 and 60, which permit the court to set aside or change an order pursuant to a motion, and determined that neither one applies unless a final judgment has been entered. *Id.* Turning to local court rules, the court noted that a party may move for reconsideration after obtaining leave of court to do so. *Id.* (citing CIV. L.R. 7-9(a)). Although Mayo did not comply with these requirements, the court construed his motion under Civil Local Rule 7-9 and continued its analysis.

[32] *Mayo*, 258 F. Supp. 2d at 1104.

[33] *Id.* at 1116.

[34] *Id.* at 1105.

federal law,[35] and (3) SROs have no obligation to comply with conflicting state regulations.[36]

A. *Exchange Act Preemption*

The court reasoned that because the Securities Exchange Act grants the SEC broad supervisory powers over SROs, which such organizations must follow,[37] SROs have no authority to act independent of SEC oversight.[38] Although Congress has not expressly stated that federal regulation preempts state laws affecting SROs, the court noted that state law may not conflict with federal law or "'stand[] as an obstacle'" to the regulatory objectives.[39]

Giving deference to the position of the SEC, the court noted that the regulatory agency itself is in the best position to interpret the Securities Exchange Act and to decipher which state laws stand as an obstacle to its implementation.[40] Because NYSE Arbitration Rule 600(g)[41] made clear that the Standards would not apply to SROs, the NYSE rules promulgated under SEC authority were in direct conflict with the new Standards. Because Mayo had specifically chosen the NYSE rules in his agreement to arbitrate before the NYSE, the conflicting Standards were preempted by the federal law selected by the parties to govern the arbitration.[42] Additionally, the court noted that allowing states to adopt varying requirements governing SROs would conflict with the policy of maintaining uniform procedural rules for arbitration of claims involving federally regulated SROs.[43]

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[35] *Id.* at 1111. Most conflicting is NYSE Arbitration Rule 600(g), enacted in response to the Standards, requiring California investors to either waive the Standards in order to arbitrate in California, or else arbitrate out of state. *Id.* at 1105. Also in conflict were provisions of the Standards which require greater disclosure than the NYSE rules and provisions of the Standards which would provide disqualification of arbitrators or vacatur of awards when the NYSE would not. *Id.* at 1110. The court also found that allowing states to impose their own standards on SROs would conflict with the federal policy of maintaining a uniform and national securities regulation scheme. *Id.* at 1110–11.

[36] *Id.* at 1112.

[37] *Mayo*, 258 F. Supp. 2d at 1112.

[38] *Id.*

[39] *Id.* at 1107.

[40] *Id.* at 1109 n.15.

[41] *See generally id.* at 1103 n.7, 1106 (providing a brief history of NYSE Rule 600(g)).

[42] *Mayo*, 258 F. Supp. 2d at 1110.

[43] *Id.* at 1111 ("An important function of the SROs is to conduct securities arbitrations throughout the United States, and the SEC oversees the SRO arbitration

B. *FAA Preemption*

The court also found that the FAA preempted the new California Standards.[44] Noting that the FAA was passed as a means of enforcing arbitration agreements, the court found that Mayo had chosen the NYSE as the arbitral forum and agreed to be bound by its rules.[45] Federal policy is not to arbitrate under a certain set of specific rules, but rather to enforce the agreement as chosen by the parties.[46] By choosing the NYSE, Mayo "incorporated the NYSE arbitration rules into his agreement to arbitrate," and his agreement "neither contemplates nor allows for application of the California standards."[47] The court found that, under the FAA, Morgan Stanley had a right to enforce the agreement to arbitrate under its terms.[48]

IV. IMPLICATIONS OF THE RULING

On its face, the *Mayo* decision seems fair—the parties agreed to be governed by the NYSE rules by choosing it as the forum; therefore, the NYSE rules should apply. Closer examination reveals the difficult reality of Mayo's situation and that of the thousands of people who file claims against SROs each year.

The California Legislature and the California Judicial Council enacted the new ethics standards in an effort to require greater disclosure by arbitrators and boost public confidence in the fairness of the arbitration system.[49] The Standards require heightened disclosure in situations involving consumer arbitrations when a contractually designated dispute resolution provider is administering the arbitration.[50] These new requirements were intended to provide additional protection to consumers who have little opportunity to negotiate the terms of their account agreements.

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programs. In accordance with the federal regulatory scheme, the SRO arbitration rules apply uniformly across the states.").

[44] *Id.* at 1114.

[45] *Id.*

[46] *Id.* at 1113.

[47] *Mayo*, 258 F. Supp. 2d at 1113.

[48] *Id.* at 1114 (finding that the FAA allows for the revocation of an agreement to arbitrate upon only those general grounds existing at law for the revocation of *any* contract). "Courts may not, however, invalidate arbitration agreements under state laws applicable only to arbitration provisions," and the California Standards clearly applied only to arbitration agreements. *Id.* (quoting Doctor's Assocs. Inc. v. Casarotto, 517 U.S. 681, 687 (1996)).

[49] *See id.* at 1100.

[50] *Id.* at 1100–01.

It has increasingly become industry standard in the investment and banking community to require the arbitration of complaints in the terms and conditions of account agreements.[51] Because Mayo and millions of investors like him must agree to the non-negotiable terms of securities companies like Morgan Stanley in order to open an account, they are left with no option but to agree to the investment company's conditions. Consumers of financial services are thus stuck when the federal law to which they are contractually bound provides less protection than the laws of their state.

Speaking just prior to the *Mayo* case, William Kennedy, the California securities lawyer representing Mayo, stated:

> No court has found that when parties agree to arbitrate in front of the NYSE, American Arbitration Association or any other arbitration forum it therefore means (they are) waiving all of the state law. Maybe it never came up. Maybe no one ever pushed the argument because they thought it wouldn't win.[52]

The United States District Court for the Northern District of California, however, has now decided that this argument does win.

Kennedy argued that the disclosure requirements in California would primarily involve data entry into a software program designed to keep records of cases, protecting consumers from arbitrator conflicts of interest.[53] Additionally, the California Standards provide arbitrators with a more explicit list of potential conflicts, rather than leaving the decision to disclose certain issues to the arbitrator's discretion.[54] More explicit standards, he stated, could actually save time by informing all involved parties—including the arbitrator—of which situations are grounds for vacatur of an arbitration award.[55] But because the Standards are state law, they will not apply in cases similar to *Mayo*.

In the end, *Mayo* is a victory for the securities industry. The court did, however, limit the implications of the case to the specific facts involved, stating that "[i]f an arbitration agreement allowed for application of California arbitration rules, the FAA preemption analysis might yield a

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[51] *See generally* Alan S. Kaplinski & Mark J. Levin, *Consumer Financial Services Arbitration: Last Year's Trend Has Become This Year's Mainstay*, 54 BUS. LAW. 1405 (1999).

[52] *California Hearing to Challenge SRO Arbitration Standards*, SEC. WK., Feb. 10, 2003, at 4.

[53] *Id.*

[54] *Id.*

[55] *Id.*

different result."[56] It seems unlikely, however, that any securities firms will change their arbitration clauses to allow for the application of the stricter California ethics standards.

Robin L. Grant

[56] *Mayo*, 258 F. Supp. 2d at 1114.